Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-2695-00
RJWright

date:

to: District Director, Brooklyn
Attn: Greta McPherson, Group Manager 1045

from: District Counsel, Brooklyn District, New York

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ubject: [redacted]
TIN: [redacted]
[redacted] Tax Year

ISSUE

Whether the taxpayer is entitled to an immediate deduction for a payment labeled "mortgage prepayment premium" that was made in order to secure a mortgage modification and extension agreement?

FACTS

The facts, as we understand them to be, are as follows. On [redacted], the taxpayer, [redacted], entered into a loan agreement labeled "Mortgage Modification and Extension Agreement." Under this agreement, [redacted], as mortgagor, and the [redacted], as mortgagee, agreed to "extend, modify and restate the terms and provisions contained in the Existing Notes and Existing Mortgages." The aforementioned "existing notes and mortgages" referred to the debts that had been consolidated pursuant to a "Note Consolidation, Modification and Extension Agreement" dated [redacted] and entered into by [redacted] and the [redacted]. The following notes were consolidated pursuant to the [redacted] agreement:

	Lender	Amount	Date of Loan
1.	[redacted]	$[redacted]	[redacted]
2.	[redacted]	$[redacted]	[redacted]
3.	[redacted]	$[redacted]	[redacted]
4.	[redacted]	$[redacted]	[redacted]

5. [redacted] $[redacted] [redacted]

6. [redacted] $[redacted] [redacted]

The first two of the above-listed loans in the amounts of $[redacted] and $[redacted] were consolidated in a consolidation and extension agreement entered into by [redacted] and the [redacted] on [redacted]. The total consolidated amount of these loans was $[redacted]. On [redacted], the same parties agreed to another loan consolidation encompassing the $[redacted] consolidated loan and loans 3 - 5 from the list above. The total amount of this consolidation was $[redacted]. In the note consolidation, modification and extension agreement signed on [redacted], the parties agreed to further consolidate the remaining balance of the $[redacted] loan with the $[redacted] loan executed on that same day. The total amount consolidated was $[redacted].

When the [redacted] modification agreement was executed, the unpaid principal balance of the existing notes and mortgages totaled $[redacted]. The new modification agreement extended the maturity date of these notes from [redacted] to [redacted]. In addition, the interest rate was lowered from [redacted]% per annum to [redacted]% per annum. Last, the agreement provided that the consolidated mortgages would constitute a single, first mortgage lien on the mortgagor's property located at [redacted].

As a result of agreeing to the [redacted] loan modification agreement, [redacted] was required to pay a prepayment premium. According to Exhibit A of the agreement reached on [redacted], if [redacted] prepaid the note during the prepayment period, which stretched from [redacted] to [redacted], it was obligated for a prepayment premium in the amount of [redacted]% of the unpaid principal balance of the note. Accordingly, at the [redacted] closing, [redacted] paid a prepayment penalty in the amount of $[redacted] which is [redacted]% of the $[redacted] outstanding loan.

On its [redacted] Form 1065, U.S. Partnership Return of Income, [redacted] deducted the entire amount of the prepayment penalty. [redacted] also claimed a current deduction for unamortized mortgage cost in the amount of $[redacted].

Since there are significant timing advantages for the taxpayer in claiming a current deduction of the entire prepayment penalty on its [redacted] tax return, advice has been requested as to whether the penalty should be amortized over the term of the loan executed on [redacted], rather than deducted in full on the taxpayer's [redacted] tax return.

The taxpayer argues that the loan executed on [redacted] contained terms that differed materially from the prior loan agreement executed on [redacted]. Accordingly, the taxpayer states that the [redacted] loan qualifies as a new loan for tax purposes and that the prepayment penalty is deductible in the year of payment.

LEGAL ANALYSIS

Section 162 of the Internal Revenue Code allows a deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) of the Income Tax Regulations states that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

In particular, section 163 of the Code permits a deduction for all interest paid or accrued within the taxable year on indebtedness. However, prepaid interest is not currently deductible and, if it is not personal interest, is generally deductible over the life of the loan. Cash-method taxpayers are deemed to be on the accrual method for purposes of claiming deductions for prepaid interest, regardless of whether income would be materially distorted. Internal Revenue Code § 461(g). In fact, section 461(g)(1) requires a cash-method taxpayer to charge prepaid interest to a capital account and to deduct the prepaid interest in the period in which (and to the extent that) the interest represents a charge for the use or forbearance of borrowed money during each such tax year.

Section 263 of the Code governs whether a legitimate business expense is currently deductible. Section 263(a) of the Code disallows a deduction for an amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Regulation section 1.263(a) includes as examples of capital expenditures the cost of acquisition, construction, or erection of buildings, machinery, equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Thus, if an amount qualifies as a capital expenditure, it is not currently deductible.

If payments serve to create or enhance a separate and distinct asset, they must be capitalized. In Woodward v. Commissioner, 397 U.S. 572 (1970), the taxpayers, who were majority shareholders, claimed an immediate deduction for the entire amount of expenses incurred in determining the value of the minority shareholders' stock interest. The U.S. Supreme Court ruled that these expenses must be capitalized because such ancillary expenses incurred in acquiring or disposing of a capital asset are as much a part of the cost of the asset as the price paid for it. The Court observed that a capitalization determination involved the simple inquiry as to whether the expenditure arose in the process of acquiring the asset.

If a taxpayer pays a fee as part of the cost of obtaining a loan, the fee should be amortized over the life of the loan since it qualifies as a capital expenditure. Detroit Consolidated Theatres, Inc. v. Commissioner, 133 F.2d 200 (6th Cir. 1942), affg. per curiam a Memorandum Opinion of the Tax Court dated August 28, 1941. In Lieber v. Commissioner, T.C. Memo 1993-391, the taxpayers (partnerships) entered into sales agreements and executed purchase money promissory notes. These notes had provisions stating that the partnerships could not prepay interest or principal for 10 years without incurring prepayment penalty fees. However, these penalties could be waived during the first five years by payment of certain fees. The partnerships paid these fees and attempted to claim a full and immediate deduction for them. However, the Tax Court held that fees paid in lieu of mortgage prepayment penalties constituted prepaid interest, and as such, were amortizable over the lives of the loans. Moreover, it reasoned that, in general, prepayment penalties on mortgage loans paid by partnerships constitute interest substitutes or additional mortgage loan fees. As interest, the prepayments should be amortized over the life of the loan. Sandor v. Commissioner, 62 T.C. 469 (1974), affd. 536 F.2d 874 (9th Cir. 1976).

However, if the prepayment premium is paid as part of the termination of an existing loan and not made to secure additional lending, it will be fully deductible in the year of payment. In The 12701 Shaker Boulevard Company v. Commissioner, 312 F.2d 749 (6th Cir. Ct. App. 1963), the Court held that the prepayment penalty was deductible in the year of payment because it was paid to extinguish an outstanding mortgage loan and it was not part of the cost of obtaining new financing. In Shaker, the taxpayer terminated a 20-year loan with one lender, and in doing so, was required to pay a prepayment penalty. Soon after extinguishing this loan, the taxpayer agreed to execute a loan with a different lender. The Court stated that "[c]ertainly in the instant case, where the new and old mortgagees were different and unrelated parties, the two mortgage loans of the petitioner cannot be said to be so related that they must be regarded as a single unit."

In this case, [redacted] has taken the position that the [redacted] and [redacted] loans were separate and distinct, notwithstanding that the parties labeled the latter loan "Mortgage Modification and Extension Agreement." The taxpayer points to Sleiman v. Commissioner, T.C. Memo 1997-530, as support for this contention. In Sleiman, the Court held that the proper amortization period for amounts paid for services rendered in connection with a construction loan was the one year period of the construction loan, and not the [redacted]-year period of the permanent loan executed by the taxpayer. In rejecting the respondent's argument that the construction loan and permanent loan should be viewed as a single loan, the Court stated that the loans had been separately negotiated and that the taxpayer had obtained a commitment for permanent financing from the lender less than a month before the due date of the construction loan. The loans were executed on different dates, for different purposes and were for different amounts. The Court noted that the "requirement of an additional commitment fee further convinces us that the permanent loan constituted a separate obligation on behalf of ME."

Aside from the fact that Sleiman dealt with the proper amortization of fees incurred in connection with a loan, and not the deductibility of a prepayment penalty, the facts in Sleiman differ significantly from the facts in this case. In Sleiman, the taxpayer executed two different types of loans- a construction loan and a permanent loan, which existed independently and were executed on different dates. Here, there is only the $[redacted] loan, which was the subject of both the [redacted] and [redacted] agreements. Moreover, the [redacted] modification and extension agreement refers to the loan executed on [redacted] and states that the existing notes were consolidated pursuant to the [redacted] agreement. These "existing notes" were the principal subject of the [redacted] agreement. But, in Sleiman, the Court pointed out that the taxpayer's construction loan documents do not refer to the permanent loan or otherwise indicate that the taxpayer bargained for permanent financing at the time it obligated itself under the construction loan. As a result, Sleiman is distinguishable from the present case.

Instead of treating the [redacted] loan and [redacted] loan as separate and distinct, the latter should be treated as a refinancing of the earlier loan. The only differences between the first loan and the second loan are the maturity date and the applicable interest charge. The [redacted] loan lowered the interest rate from [redacted]% to [redacted]% and extended the maturity date from [redacted] to [redacted]. The [redacted] did not lend [redacted] additional funds in the later agreement.

Rather, the subject of the subsequent loan was the unpaid principal balance of the loan executed on [redacted]. Moreover, the same parties executed each agreement and labeled the later agreement "Mortgage Modification and Extension Agreement".[1]

Accordingly, the [redacted]% prepayment penalty is a capital expenditure and is not deductible in full in the year of payment. The prepayment penalty was a fee paid to obtain a lower interest rate and a longer loan maturity. It was not made to extinguish [redacted] existing loan. Since the prepayment penalty was paid to obtain a lower interest rate that accrues over the life of the [redacted] loan, it should be amortized over the life of this loan. Lieber v. Commissioner, T.C. Memo. 1993-391. *See also* Detroit v. Consolidated Theatres, Inc. v. Commissioner, 133 F.2d 200 (Ct. App. 6th Cir. 1942). This result conforms with the general rule that prepayment penalties on mortgage loans to partnerships are interest substitutes or additional mortgage loan fees and should be amortized over the life of the loan. Lieber v. Commissioner, *supra*.

CONCLUSION

The $[redacted] prepayment premium paid by [redacted] incident to securing the [redacted] modification and extension agreement does not qualify as a deduction under Internal Revenue Code sections 162 and 163. Rather, it constitutes a capital expenditure and should be amortized over the life of the [redacted] loan agreement consistent with the capitalization rules embodied in Code section 263.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

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[1] In fact, the same parties had entered into three prior modification and extension agreements prior to the [redacted] agreement.

DISCLOSURE STATEMENT

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